OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19034399
P. HURST, SR. AND J. HURST	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellants: Jay Soni, EA

For Respondent: Brad J. Coutinho, Tax Counsel III
Marguerite Mosnier, Tax Counsel IV

K. GAST, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, P. Hurst, Sr. and J. Hurst (appellants) appeal actions by respondent Franchise Tax Board (FTB) denying their protest of the following two proposed assessments: (1) tax of $20,770, a late-filing penalty of $5,192.50, and an accuracy-related penalty of $4,154, plus interest, for the 2008 tax year; and (2) tax of $13,893 and an accuracy-related penalty of $2,778.60, plus interest, for the 2009 tax year.

Administrative Law Judges Kenneth Gast, Linda C. Cheng, and Nguyen Dang held an oral hearing for this matter in Cerritos, California, on January 22, 2020. At the conclusion of the hearing, the record was closed, and this matter was submitted for a decision.

ISSUES

1. Whether, for the 2008 and 2009 tax years, appellants have shown error in FTB's proposed assessments.
2. Whether, for the 2008 tax year, appellants are liable for the late-filing penalty.
3. Whether, for the 2008 and 2009 tax years, appellants are liable for the accuracy-related penalty.

FACTUAL FINDINGS

1. Appellants filed an untimely joint 2008 California resident income tax return, and a timely joint 2009 California resident income tax return. They reported zero tax on both returns.
2. Subsequently, the Internal Revenue Service (IRS) audited their 2008 and 2009 federal tax returns, and for both years, increased their taxable income and assessed additional tax and penalties, plus interest. These adjustments went final and appellants did not report them to FTB.
3. Based on the IRS information, FTB made corresponding adjustments and issued Notices of Proposed Assessment (NPAs) for the 2008 and 2009 tax years, in the amounts noted above.[1]
4. Appellants protested the NPAs, but FTB affirmed them by issuing Notices of Action. This timely appeal followed.

DISCUSSION

Issue 1 – Whether, for the 2008 and 2009 tax years, appellants have shown error in FTB's proposed assessments.

R&TC section 18622(a) requires a taxpayer to concede the accuracy of a federal change to a taxpayer's income or to state where the change is erroneous. It is well settled that a deficiency assessment based on a federal adjustment to income is presumed correct and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Appellants contend they maintained business and personal bank accounts, but the IRS improperly double-counted as their income funds they transferred from one account to another

[1] For the 2008 tax year, FTB increased appellants' taxable income by $304,085, as follows: $142,625 of Schedule C gross receipts or sales; $30,800 of individual retirement arrangement; $30,442 of Schedule C other expenses; $35,000 of Schedule C wages; $77,717 of Schedule E real estate loss; ($3,927) of self-employment tax deduction; $13,078 of medical deduction; ($12,859) of home mortgage interest; and ($8,791) of contributions.

For the 2009 tax year, FTB increased appellants' taxable income by $267,912, as follows: $68,157 of Schedule C gross receipts; $1,358 of interest income; $71,064 of Schedule C other expenses; $44,940 of Schedule E real estate loss; $43,000 of Schedule C wage expenses; ($4,625) of self-employment tax deduction; $14,575 of medical deduction; $22,777 of mortgage interest deduction; and $6,666 of contributions.

that did not represent new deposits of income. However, we must reject this contention because they have not provided documentation showing the IRS improperly overstated their income.

Appellants next contend FTB incorrectly disallowed expense deductions they paid related to rental real estate property located in Moreno Valley, California, because the mortgage was in the name of their son, not theirs. They assert that since the title of the property was in their names, they are allowed expense deductions on federal Schedule E, which is used to report, among other things, rental real estate income and expenses.[2] We disagree.

On their 2008 and 2009 Schedule E, appellants already deducted expenses related to the property in question, and FTB does not dispute they are entitled to the claimed deductions. Indeed, these expenses fully offset all the reported rental income associated with that property, producing a net loss. Simply stated, appellants have not demonstrated the alleged unclaimed rental expenses were not already deducted on Schedule E. To allow the disputed deductions would be duplicating or double-counting what FTB had already allowed.

In addition, FTB properly denied as a deduction against appellants' ordinary income (i.e., Schedule C business income) an excess passive activity loss of $77,717 and $44,940 claimed on their 2008 and 2009 Schedule E, respectively, which consisted of a combined net loss from the property in question and other rental real estate properties. California generally conforms to Internal Revenue Code (IRC), section 469, which prohibits the use of passive activity losses (e.g., rental real estate activity losses) from reducing non-passive activity income (e.g., wages or business income). (R&TC, §§ 17551(a), 17561.) Rather, passive losses may be deducted only to the extent of income from passive activities, and any unused passive losses are suspended and carried forward to future years to offset passive income generated in those years. (See *Lowe v. Commissioner*, T.C. Memo. 2008-298, 2008 WL 5396602 at p. *3.)

Therefore, even assuming, without concluding, appellants owned the property in question and paid the alleged expenses, they are not entitled to an increased passive activity loss deduction because they already offset all of their passive income from their rental real estate

[2] Specifically, appellants allege these expenses total $22,100.03 and $18,934.39 for 2008 and 2009, respectively. These expenses include mortgage interest and real estate taxes, and fees associated with homeowner's association, water district, waste management, and pest control. As support, they submit schedules, property tax payments, IRS Forms 1098 (mortgage interest statement), and bank statements. However, we note that some of the alleged expenses do not tie dollar-for-dollar to the support provided.

activities on Schedule E and cannot offset such excess losses against ordinary income.[3] Moreover, appellants have not substantiated they are entitled to an increased passive activity loss carryforward beyond the $77,717 and $44,940 reported on their 2008 and 2009 Schedule E. Accordingly, appellants have not carried their burden of proving FTB's proposed assessments are in error.

Issue 2 – Whether appellants are liable for the late-filing penalty for the 2008 tax year.

R&TC section 19131 imposes a penalty for the failure to file a return on or before the due date, unless it is shown that the late filing is due to reasonable cause and not due to willful neglect. The late-filing penalty is computed at five percent of the amount of tax required to be shown on the return for every month that the return is late, up to a maximum of 25 percent. (*Ibid.*) Here, we find FTB properly imposed the late-filing penalty, and appellants have not argued otherwise.

To establish reasonable cause, "the taxpayer must show that the failure to file timely returns occurred despite the exercise of ordinary business care and prudence, or that such cause existed as would prompt an [ordinarily] intelligent and prudent business[person] to have so acted under similar circumstances." (*Appeal of Tons* (79-SBE-027) 1979 WL 4068.) The burden of proof is on the taxpayer to establish reasonable cause exists to support an abatement of the penalty. (*Ibid.*) Appellants assert that Mr. P. Hurst, Sr. (appellant-husband) was (and still is) suffering from cancer, but they do not specifically allege that his illness caused the late filing when the 2008 return became due on April 15, 2009. In any event, appellants submit no documentation showing when, and to what extent, appellant-husband was ill. Accordingly, they are liable for the late-filing penalty.

Issue 3 – Whether appellants are liable for the accuracy-related penalty for the 2008 and 2009 tax years.

R&TC section 19164, which generally incorporates IRC, section 6662, provides for an

[3] California does not conform to IRC section 469(c)(7), which allows taxpayers who materially participate in the real property business to treat rental real estate activity losses as nonpassive losses for federal purposes. (See R&TC, § 17561(a).) And although California does conform to IRC section 469(i), which permits an offset of up to $25,000 of rental real estate losses against ordinary income for individuals who actively participate in rental real estate activities, there is a complete phase-out if the taxpayer's adjusted gross income (AGI) exceeds $150,000. (See R&TC, §§ 17551(a), 17561(d); IRC, § 469(i)(3)(A).) Therefore, without needing to decide whether appellants actively participated in rental real estate activities, they are not allowed any offset against their ordinary income under this rule because, in FTB's NPAs, their recomputed AGI exceeds $150,000 for both 2008 and 2009.

accuracy-related penalty of 20 percent of the applicable underpayment. As relevant here, the penalty applies to the portion of any underpayment attributable to any substantial understatement of income tax. (IRC, § 6662(b)(2).) For individuals, such as appellants, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1)(A).) Here, since we find FTB properly imposed the accuracy-related penalties and appellants have not shown or argued otherwise, they are liable for these penalties.

HOLDINGS

1. Appellants have not shown error in FTB's proposed assessments for the 2008 and 2009 tax years.
2. Appellants are liable for the late-filing penalty for the 2008 tax year.
3. Appellants are liable for the accuracy-related penalty for the 2008 and 2009 tax years.

DISPOSITION

FTB's actions are sustained in full.[4]

DocuSigned by:
Kenneth Gast
FD75A3136CB34C2...
Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
8B585BEAC08946D...
Linda C. Cheng
Administrative Law Judge

DocuSigned by:
Nguyen Dang
4D465973EB44469...
Nguyen Dang
Administrative Law Judge

Date Issued: 2/27/2020

[4] Appellants assert that serious financial hardship will result if they were forced to pay the entire proposed assessments. They request that FTB reduce the liabilities they owe to an equitable figure, similar to what the IRS did when it accepted their federal offer in compromise (OIC) covering the same years at issue. However, there is no authority that requires—or authorizes us to compel—FTB to adjust its proposed assessments based on the IRS' acceptance of appellants' federal OIC. Their federal OIC is based on doubt as to collectability, not the IRS' substantive determination, of the amounts due. When this appeal is completed and the deficiencies at issue become final, appellants may seek to participate in FTB's OIC program.